Sourcing Investment Ideas

I vividly recall sitting in multiple finalist presentations where the prospective clients' gotcha question was "Can you please tell us how you source investment ideas?". I could always tell this was a loaded question because everyone has an opinion on the best ways to source investment managers. Also, everyone tends to have an opinion of what they consider the attributes of a high-caliber manager, so there is a lot of passive-aggressive projection going on in these beauty pageant affairs. I knew my straightforward answer to this inquest did not carry the avant-garde (finding ideas in an enchanted garden called 'Guaranteed Outsized Returns' tucked beneath every fourth magical toadstool) oomph they were seeking. But with all sincerity, in my career as an allocator for the past 20+ years, the sourcing of investment ideas has never been a critical issue. I need to clarify this – I am not saying that finding high-quality managers is not a big deal, it is, but what I am trying to underscore is that exposure to a pool of investible ideas should not be a problem for anyone who has the capital to invest. If you have capital to invest, have possession of a device like a computer or phone, are open to speaking to people in the industry, and have some sort of sensitivity process, finding investment ideas should not be an overly daunting task.

In an effort not to oversimplify the sourcing of good investible ideas, the "pool" must be differentiated from the "fish". Continuing to beat this metaphor to a pulp, certain questions are appropriate to ask – Do some pools offer better fish than others? Are certain pools likely to improve your chances of catching good fish? Do certain pool characteristics alert you to the quality of housed fish? Does the history of fish caught in a specific pool provide enough information for fisherfolk to focus on that pool predominantly? Many would answer these questions with an emphatic "Yes". But my skeptical, cynical, and clinically diagnosed nonconformist nature steers me to put forth an annoying "Maybe" response. Life is not that easy, so it would be silly to believe that investing is that straightforward. Investment analysts must earn their stripes (as well as uphold the allure of their enigmatic skill sets - hahaha). Sourcing investment ideas, particularly in the private assets space, is a nuanced endeavor that takes a relatively long time to yield proof of success.

Diversification is the lifeblood of any astute portfolio construction undertaking. In my view, diversification does not only apply to the constituents (asset class, sectors, geography, investment managers, etc.) of a portfolio, it is also relevant to the way these constituents are sourced. There is substantial merit in searching for portfolio components from wide-ranging areas. Doing so not only reduces the risk of obstructing the desired benefits of varied correlations, but it also helps create comfort that you have not unwittingly fallen victim to the silent killers of open-mindedness – aka group think and echo chamber investing. Investing with the crowd is not always a bad thing, just like investing all alone is not always good. But I believe what is almost always bad is investing without free thought and critical thinking. Like in life, nothing is promised in the world of investing, so thinking that you have found some hidden holy grail of surefire investing is reckless at best.

Let's say you went to Trader Joe's and on a whim decided to try out the frozen chocolate croissants, and let's just say they turned out to be super delicious. Based on that, no one could label you as unreasonable for wanting to try the frozen almond croissants of the same brand, because the only variation here is the almonds. It is reasonable to infer that the almond croissants would also be delicious. To verify this inference, the only requirement is to leave the frozen treats out for nine hours to thaw/rise and then bake at 425 degrees for 25 minutes - within about 10 hours, voila, there is the answer. Private investing is vastly different - you generally need about five years just to find out where your money went, and another five to assess how much longer it will take to attain a tangible return. I am being a little facetious, but my teasing is not that far from the truth. With past performance being a porous receptacle for future investment performance confidence, and the length of time needed to garner any semblance of success, what can an analyst depend on to fortify the sourcing of investment ideas? My answer is “process”, “open-mindedness”, and a clear understanding of the “known” and “unknown”.

“Process” is critical, particularly when you meet a manager with desirable attributes on the surface. “Process” is the great equalizer – quantitative and qualitative processes ensure that regardless of how investment ideas got to your desk, they will all go through similar assessment procedures. “Open-mindedness” allows for flexibility within the process – it allows the analyst to use curiosity and improvisation to give opportunities that don’t resemble the norm a fair shot. “Open-mindedness” is what provides the plasticity to assess nontraditional track records, unconventional strategies, and innovative solutions, as well as the empowerment to triangulate/confirm unofficial attribution. Having a firm grip on what can be “known” (or what is foreseeable) and what shall remain “unknown”(or unforeseeable) brings into clearer focus the leap required to proclaim conviction. When/if things go wrong with an investment, the learning/postmortem process is more graspable when the “foreseeable” aspects that you took a risk on occur. There is no reward without risk, but the risk must be calculated. On the other hand, if the truly “unforeseen” or “unknowable” occurs with an investment, the only real lesson is “life happens”.

Okay, back to straight-up investment idea sourcing. The possibilities are endless when seeking investible ideas. I have always been a big fan of funds of funds as a great source of names – any organization that focuses on a particular investment segment day in and day out ultimately develops very valuable insights. I also use reference calls (especially ones with nontraditional or below-the-radar LPs) as a way to find managers who don’t cross my path – for guarded LPs reluctant to share names, I usually offer up my whole pipeline to help lubricate their divulgence. Trusted, placement agents who have taken the time to learn my requisites are another good source for interesting names – I however always ask them to surprise me with some opportunities that may not (in their view) be a perfect fit so I don’t fall into a bias cycle – I also make time for new placement agents who might be housing some hidden gems. Other than the above-mentioned channels, personal networks, cold inbounds, annual meetings, managers’ competitive landscapes, magazine/newspaper articles, TV shows, LinkedIn, emerging manager seminars, industry conferences, brand labels, investment committees, client inquiries or past holdings, etc. are all fertile grounds for finding your next best idea. You must be in the flow.

Apologies for the earlier rambling example about the Trader Joe’s croissants – those yummy suckers are living rent-free in my mind.

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